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by Luigi Perin

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Italy Enacts Major Changes in International Taxation With the 2000 Tax Bill

by Luigi Perin

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On November 8, the Italian Parliament finally passed into law the long-awaited tax bill for 2000, which was submitted by the government November 15, 1999, and which is part of the Annual Fiscal Law for 2000. The tax bill is not to be confused with the recently proposed draft of the year 2001 tax bill (for prior coverage, see *Tax Notes Int'l*, Oct. 16, 2000, p. 1756, or *2000 WTD 197-4*, or *Doc 2000-26137 (5 original pages)*), which is part of the Annual Fiscal Law for 2001.

The original tax bill, proposed by both chambers of the Italian Parliament, went through several amendments in the past months before the Parliament produced the final text, which is comprised of 102 articles.

The tax bill introduces important changes to the tax treatment of Italian outbound international transactions. The principal changes concern the introduction of controlled foreign company (CFC) legislation, the amendment of certain antiavoidance provisions for transactions incurred by Italian enterprises with tax havens, and the broadening of the participation exemption provisions. The tax bill also confirms the repeal of the foreign earned income exclusion for Italian individuals employed abroad. Among other domestic provisions is a drastic reform of the Italian estate and gift tax system.

CFC Legislation

In response to the 1998 OECD report, "Harmful Tax Competition: An Emerging Global Issue," encouraging countries without CFC rules to introduce them, Italy has enacted antideferral legislation. The Italian CFC rules adopt a jurisdictional approach, concentrating on the location of the subsidiary company, as opposed to the U.S. CFC rules that adopt substantially a transactional approach, concentrating on the nature of the income.

The new provisions, which introduce article 127 bis to the Italian Income Tax Code,[1] provide that when an Italian resident controls a company, business, or other entity that is either resident or located in countries or territories enjoying preferential tax treatment, the income earned by such controlled foreign entity is attributed pro rata, based on their respective investments, to the Italian residents. The above provisions also apply to income earned through permanent establishments enjoying preferential tax treatment.

[1]Testo Unico delle Imposte sui Redditi, approved by Decreto del Presidente della Repubblica No. 917 of December 22, 1986.

For the definition of "control," reference is made to article 2359 of the Italian Civil Code, defining control as ownership of the majority of voting rights, ownership of voting rights sufficient to exercise a dominant influence at the ordinary shareholders' meeting, or dominant influence by special contractual ties with the other company.

As a result, the definition of control for purposes of the CFC rules is different from the broad definition applicable under the transfer pricing provisions.[2]

A blacklist to be issued by the Italian Minister of Finance will indicate countries and territories with "preferential tax regimes." The new rules provide that the term "preferential tax regime" is to be interpreted as a tax regime providing a lower level of taxation as compared to the one applicable in Italy, no adequate exchange of information, or other similar criteria.

As a result, it appears as if the tax authorities will have broad discretion in preparing the blacklist. Presumably, the list will be inspired by the OECD list, identifying tax haven jurisdictions that have not cooperated with the organization's campaign against harmful tax practices, and it will include the countries that are listed in a different blacklist, which is in effect for certain antiavoidance provisions discussed below. It not clear yet whether the blacklist of the Italian authorities will include preferential tax regimes among OECD member states that can be considered as constituting harmful tax practices.

The CFC rules will not apply to the income earned through low-taxed persons that are primarily engaged in actual industrial or trading activities within the country or territory in which their place of business is located. Also, the CFC rules do not apply if the taxpayer can prove that the investment in the CFC does not have, as a result, the sheltering of income in countries or territories with preferential tax treatment. Under all of the above circumstances, Italian taxpayers must apply for a ruling.[3]

The CFC income attributed to an Italian resident will be taxed according to the taxpayer's average tax rate, but at a rate no lower than 27 percent. The most controversial issue of the new provisions appears to lie on the definition of person (soggetto) for purposes of computing control. Absent constructive ownership rules within the framework of the Italian tax system, it is not clear to what extent ownership by separate persons may be aggregated for purposes of establishing the required level of control and imputing the income pro rata.

Another critical issue that needs clarification concerns the mechanics of distributions and adjustments to basis with respect to the stock of a CFC. In general, under U.S. rules, the basis in the stock of a CFC is increased by the amount of CFC income included in the U.S. shareholder's taxable income, as if a dividend had been paid and then recontributed to the CFC, and reduced by amounts actually distributed that constitute previously taxed earnings. The tax bill does not provide any specific provisions addressing this issue.

Transactions With Tax Havens

The tax bill substantially modifies the provisions contained in article 76(7 bis) of the Italian Income Tax Code regulating the disallowance of costs and expenses for transactions incurred by Italian businesses with affiliated companies located in tax havens.

First, the new provisions replace the term "company" (societa) with the term "business" (impresa). As a result, transactions incurred with persons other than companies — for example, permanent establishments or individual entrepreneurs — that are based in tax havens will come within the scope of the antiavoidance provisions. Most importantly, the new provisions do not require, in order for the deduction to be disallowed, that the nonresident trade or business be an affiliate of the Italian taxpayer incurring the expense.

In addition, a revised blacklist, inspired by the same broad criteria of the blacklist to be used for purposes of the CFC rules discussed above, will indicate the countries and territories deemed to have a preferential tax regime and will replace the blacklist in effect.[4]

Finally, the new provisions limit the scope of the safe-harbor exceptions to the general rule. The current law provides that deductions will not be disallowed if it is proved that either the nonresident entity is, in effect, primarily engaged in an active trade or business, or that the transactions incurred with the nonresident entity actually took place in the best economic interest of the Italian resident.

For the safe-harbor exception to apply, the new provisions require that the nonresident be primarily engaged in actual industrial or trading activities within the market of the country or territory in which

[2]For a discussion of the definition of control under Italian transfer pricing rules, see A.A. Rossi — L. Perin, *Transfer Pricing International: A Country-by-Country Guide*, 25-4, (edited by R. Feinschreiber, J. Wiley & Sons, 2000).

[3]Pursuant to Article 11 of Law No. 212 of August 27, 2000.

[4]Released with Decreto Ministeriale of April 22, 1992.

it is located. Such revised language is similar to the language used for purposes of the safe-harbor provision to the CFC rules discussed above. Not only must the nonresident be primarily engaged in industrial or trading activities, but it must be so engaged within the market of the country or territory where its place of business is located. A literal interpretation of the new provision would deny deductions for purchases of goods and services from unrelated parties that are residents of tax havens, even if these parties actually carry out real economic activities (for example, banking, trading) simply because they do not engage in industrial or trading activities within the market of the country or territory where their business is located.

Participation Exemption

Article 96 of the Italian Income Tax Code provides that, subject to certain requirements, only 40 percent of the dividends paid to Italian corporate shareholders by non-EU foreign affiliates not located in tax havens are includable in taxable income. This results in a 14.8 percent effective tax rate (40 percent x 37 percent; 37 percent is the regular corporate income tax).

Article 96 bis of the Italian Income Tax Code, implementing the European Union Parent-Subsidiary Directive,[5] provides that, subject to certain requirements, only 5 percent of the dividends paid to Italian corporate shareholders by companies resident in the European Union are includable in taxable income. This results in a 1.85 percent effective Italian tax rate (5 percent x 37 percent).

In the past several years, it has been common for Italian multinational groups with non-European affiliates to hold their overseas investments through intermediate EU holding companies located in countries with broader participation exemption regimes (for example, the Netherlands, Luxembourg). This type of ownership structure permitted the groups to benefit from the 95 percent exclusion, provided by article 96 bis, for dividends that would otherwise be entitled to only the 60 percent exclusion discussed above.

The new provisions extend the 95 percent exclusion to dividends received by Italian corporate shareholders from foreign affiliates that are residents of countries included in a "white-list" of non-tax-haven jurisdictions to be issued by the Italian Minister of Finance. The "white-list" should be the approximate corollary of the blacklist discussed above, identifying countries or territories with preferential tax regimes. Accordingly, prerequisites to achieve "white-list" status will be the existence of both a level of taxation comparable with Italy's and an adequate exchange-of-information system.

Unlike regimes in effect in other EU countries, the new Italian participation exemption will not provide relief from taxation of capital gains arising from the sale of shares of subsidiaries. The absence of this additional exemption will still make other EU countries attractive to Italian groups for purposes of establishing a holding company. However, if as a result of the new CFC provisions, capital gains untaxed in other EU countries are taxed directly to the Italian resident, the principal incentives for Italian multinationals to hold their overseas investments through an EU intermediate holding company will eventually disappear.

Repeal of the Foreign Earned Income Exclusion

In 1997, Italy repealed the foreign earned income exclusion, with provisions effective January 1, 2001.[6] As a result, beginning next year, income from dependent personal services performed exclusively abroad on a continuous basis by Italian residents will no longer be excluded from taxable income.

The government report on the new law acknowledged the practical difficulties that would stem from the repeal, which could eventually result in double taxation for Italian residents who, although resident in Italy for tax purposes, are working in another country in which they are subject to tax. Since the new provisions were passed in 1997, other provisions have been enacted in an attempt to eliminate or reduce potential issues of double taxation.[7] However, during this period, Italy has failed to introduce provisions that would effectively improve its foreign tax credit mechanism, the defects of which are responsible for not alleviating double taxation issues.

The tax bill repeals the provisions that were previously enacted to reduce double taxation issues, and it introduces new provisions. According to the new rules, dependent personal services performed exclusively abroad on a continuous basis, by Italian residents abroad for at least 183 days during a 12-month period, will not be taxed based on the actual salaries earned. Instead, they will be taxed based on predetermined amounts to be set by an ad hoc ministerial decree.

[5] EU Directive 90/435, introduced in Italy with Decreto Legislativo No. 136 of March 6, 1993.

[6] *See* Article 5 of Decreto Legislativo No. 314 of September 2, 1997.

[7] *See* Article 15 of Decreto Legislativo No. 505 of December 23, 1999.

Estate and Gift Tax Reform

The estate and gift tax reform is the result of long and controversial debates concerning the inefficiencies of estate and gift tax collection in Italy. The lower rates are intended to encourage voluntary compliance with the law and to increase the overall tax base.

Estate tax rates drop to 4 percent for spouses, lineal descendants, and ancestors. Higher rates of 6 percent and 8 percent apply to other categories of beneficiaries. Similarly, gift tax rates drop to 3 percent, 5 percent, and 7 percent, depending on the degree of relationship of the beneficiary to the donor. An ITL 350 million per beneficiary exemption is introduced for gifts.

From an international taxation perspective, the new provisions specifically allow for the taxation of gifts that are perfected abroad in favor of Italian resident beneficiaries. ✦